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Macquarie Global Listed Infrastructure[1]

Canary in the coal mine? Understanding the opportunity in airports

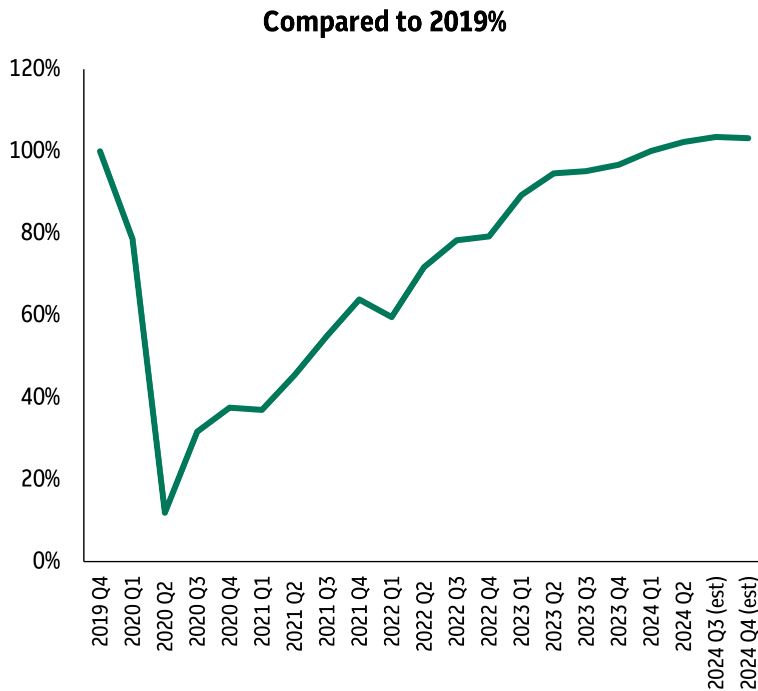
In 2020, airport traffic volumes around the world were nearly zero in April and May. The global COVID-19 pandemic and associated travel restrictions created a lot of uncertainty about the pace of the eventual recovery in volumes, and the market priced these airport assets as though the traffic would disappear forever. One did not need to have an accurate forecast of when passengers would return to see the significant valuation opportunity that the sector presented.

This is an exceptional example of the market focusing too much on the short term – in this case, focusing on short-term traffic – which then presents opportunities for investors with a longer-term perspective. In fact, there was a brief period towards the end of 2020 when we held a positive view of airports (probably the most positive we have ever had about the sector) and invested significantly in Sydney Airport and Auckland Airport when their share prices fell after the early impacts of the pandemic.

Interestingly, today we see a similar story in the same sector. However, in our view, the market is now too focused on the travel recovery story. With passenger volumes returning to pre-pandemic levels and pent-up demand driving significant travel spend across both international and domestic travelers, airports have continued to fly high. European airports (European Union (EU), European Economic Area (EEA), the UK, and Switzerland) saw an almost 122% increase in passenger volumes, according to data from Airports Council International (ACI), as more countries opened up to visitors.

[1] Macquarie Listed Infrastructure is an equity team within Macquarie Asset Management's (MAM) Equity & Multi-Asset business.

Projected global quarterly passenger traffic compared to the 2019 level
(2020–2024, quarterly indexed, 2019 level = 100%)



From here, the market expectations for continued growth in passenger volumes doesn't seem to slow down. According to ACI, global passenger numbers are expected to nearly double between 2024 and 2042 and be 2.5 times higher in 2052. By 2042, this growth rate sees international passenger traffic reaching 8.7 billion and domestic passenger traffic to attain 10.6 billion.

While on the surface the growth profile looks attractive, we believe it is another example where the market is overly focused on short-term traffic. This insight looks to dig deeper into the sector assessing the current opportunities and risks and explains our current positioning in the sector.

Source: World Airport Traffic Forecasts (WATF, aci.aero)

From an investment perspective, there are several consistent thematics worth considering:

1. Capital expenditure (capex)

While the market has been focused on the recovery in traffic post-pandemic, it has, in our view, forgotten that many airports had significant capacity constraints before the pandemic. With traffic now recovering to near or above pre-pandemic levels, market focus may eventually need to switch from near-term traffic trends to the often very significant amount of money many airports will need to invest in new terminals and runways to facilitate future growth. As regulatory approval is often needed for large capex plans, capacity constraints may mean that passenger growth slows for a few years. If growth can continue, it often comes at the expense of operating leverage, as more crowded airports require higher costs, and airports may not be able to adjust their tariffs accordingly.

Importantly, we have seen this before (the Beijing Airport is just one example) where the market shows enthusiasm about the near-term outlook for volume and revenue growth but overlooks the negative impact of required capex on free cash flow growth and the balance sheet.

In Europe, there is a clear divergence between the large, listed airport operators, with several in the middle of large capex programs and others likely needing to begin. Fraport, which was at capacity in 2019, is currently completing a more than €4 billion new terminal project (due to be opened in 2026). Meanwhile, Athens International Airport in embarking on a €650 to 700 million project to expand an existing terminal. These expansion projects are weighing heavily on cash generation at these companies. On the contrary, even though in 2019 several of the main airports were more than 90% utilised, airport operator Aena's cash flows continue to benefit from low capex. This is set to change in the next regulatory period (starting in 2027) when annual capex could potentially double to fund expansion projects across much of its network.

2. Sovereign risk

Unlike privatised listed airports such as Auckland Airport where there is a stronger alignment of interest with shareholders, some airports, such as Airports of Thailand and Athens International Airport, are majority-owned by the government. Given how important the tourism sector is to these economies, there is an ever-present risk of decisions being made that are not in the best interests of minority shareholders. A recent example of this is when

Airports of Thailand announced that it would be closing down duty-free shops at the arrivals area of its airports. This is to comply with new measures from the government aimed at encouraging travelers to spend outside rather than inside the country's airports

3. Regulation

Regulation remains a key consideration for airports. Below, we outline four examples of the potential implications..

Airport	Commentary
Auckland Airport	Recently had its draft aeronautical pricing decision and the company may need to cut tariffs depending on the final decision in early 2025.
ENAV S.p.A	ENAV is currently in discussions with the European Air Traffic Control regulator (EuroControl) for the next regulatory period (2025 to 2029). EuroControl recently announced a pan-EU target for unit cost reduction of 1.2% for the period (this drives the tariff development), which compared favourably to the ~3% unit cost reduction target in the current regulatory period.
Aeroports de Paris	Currently does not have a regulatory framework, which means that the company needs to resort to annual negotiations with the regulator to determine tariffs. While this has advantages and disadvantages, one of the key challenges has been trying to pass through higher-than-expected inflation in the last few years without a clear mechanism to do so
Aena	Aena is about to embark on regulatory discussions for the next regulatory period, which will start in 2027. One of the key considerations is the tariff projection path. During the first two regulatory periods, Aena could not raise its tariffs, but that moratorium expires with the next regulatory reset.

4. Canary in the coal mine? Short-term passenger volumes

Macquarie has recently noted that the European and US airlines are starting to announce profit warnings, cutting their 2024 guidance. These warnings have been driven mainly by weaker pricing, which suggests that demand is starting to weaken. It's not yet clear if this is a supply issue (i.e., the airlines simply put too much capacity into the market) or demand driven (no one can afford to travel because of increases in ticket prices). However, when it comes to airline profitability, pricing is, in our experience, usually the first leg to fall, followed by capacity cuts to save costs. Indeed, there seem to be two camps forming: those preparing to use price to win market share (Ryanair) and those willing to cut capacity to preserve costs (Air France-KLM and Lufthansa).

Aviation 2024 profitability commentary

Airline	Date	Commentary
Ryanair	22 July 2024	In its fiscal 1Q25 results, Ryanair noted that late bookings were weaker than expected. As a result, the company now expects fares in the summer of 2024 to be materially down year over year. The company believes that the weakness is driven by customers being more price sensitive rather than an oversupply of capacity. However, Ryanair noted that it does not plan to cut back on its capacity targets.
Lufthansa	12 July 2024, 31 July 2024	Ahead of its 2Q24 Lufthansa cited a "market-related decline in yields in all regions." The company flagged Asia as the main source of weakness. Management flagged overcapacity on most international routes and suggested that it would trim its capacity plans heading into 2H24 and 2025.

Airline	Date	Commentary
Airfrance-KLM	1 July 2024, 25 July 2024	Air France-KLM issued a profit warning on the back of weaker-than-expected revenue at Air France and Transavia for the summer season. In particular, the company noted that traffic growth to Paris is lagging other European cities as inbound travelers seem to be avoiding Paris during the Olympics. The company also noted that French citizens were avoiding travel until after the Olympics. Additionally, the company noted that summer 2024 bookings remain weak across all segments (long-haul, short-haul, and on its low-cost carrier, Transavia).

With challenges come opportunities… then and now

Along with toll roads, railways, and seaports, airports can be an attractive investment opportunity.

Then…

A covid 19 case study – Transportation

During the COVID-19 pandemic, we began conducting scenario analysis for transportation-related companies to get a feel for the range of outcomes, given the uncertainty about volumes at the time.
This was across all modes of transport: road, rail, and air. We created three macroeconomic scenarios around the pace of the recovery based on our estimates of the strongest, weakest, and most-likely cases. For road and rail, we split volumes between truck and car traffic. Given that most of the travel was domestic, the impact of from the pandemic did not last long and traffic quickly recovered to pre-pandemic levels. For example, for Vinci's French toll roads, volumes were down more than 50% year over year in 2Q20 (when the pandemic first struck) but were down only around 10% compared with 2019 by 3Q20 and were back to 2019 levels by 3Q21.
A much bigger divergence occurred at the airports, where traffic dropped almost to zero for April and May 2020, and travel restrictions created a lot of uncertainty about the pace of the eventual recovery in volumes. To better understand the sensitivities of the traffic recovery, we segmented passengers into three components: domestic, short-haul international travel (for example, pan-EU travel), and long-haul international (i.e. intercontinental). Given the various travel restrictions, we believed that each segment would face a difference recovery profile.

Now…

As a result of the broader discussion above, Macquarie has significantly lower allocation to the airport sector as of July 2024 than many peers and the S&P Global Infrastructure Index (reference benchmark). Despite this positioning, Macquarie is selectively exposed to what the team believes are the strongest opportunities in the space, including assets like ENAV, the air traffic controller in Italy, and Athens International Airport.

ENAV

Aerial view of Athens International Airport

Conclusion

Sorting through short-term noise and focusing on true opportunities is often easier said than done, but it is, in our view, a core element to delivering strong long-term returns to investors.

Over the past five years, the Macquarie Global Listed Infrastructure Team has seen two such opportunities in the airport sector. In 2020, the global pandemic and travel restrictions created a lot of uncertainty about the pace of the eventual recovery in volumes. In 2024, the market has once again become preoccupied with short-term passenger numbers. This time, however, we believe the risk is to the downside for the sector and a selective approach to positioning is key.

The above discussion serves to highlight the importance of active management and the ability to dynamically allocate based on the opportunity set. We believe that utilising a specialist infrastructure manager like Macquarie can deliver improved risk-adjusted returns to investors.

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Key risks

The potential for adverse events in the global infrastructure sector to impact the performance of the investments of the Strategy. Investments in securities issued by companies which are principally engaged in the infrastructure business will subject the Strategy to risks associated with direct investment in infrastructure assets. Factors such as the availability of finance, the cost of such finance in general as well as in comparison to prior periods, the level of supply of suitable infrastructure projects and government regulations relating to infrastructure may influence the value of these investments and hence the Strategy.

The risks of investing in the infrastructure sector include those listed here.

New project risk: Where an infrastructure issuer invests in new infrastructure projects, it is likely to retain some residual risk that the project will not be completed within budget, within the agreed time frame and to the agreed specification.

Strategic asset risk: Infrastructure assets may include strategic assets, that is, assets that have a national or regional profile, and may have monopolistic characteristics. The nature of these assets may generate additional risk given the national/regional profile and/or their irreplaceable nature and may constitute a higher risk target for terrorist acts or political actions.

Documentation risk: Infrastructure assets are often governed by a complex series of legal documents and contracts. As a result, the risk of a dispute over interpretation or enforceability of the documentation may be higher than for other issuers.

Operation risk: Should an infrastructure issuer fail to maintain and operate the assets efficiently, the ability to maintain payments of dividends or interest to shareholders may be impaired. Failure by the infrastructure issuer to carry adequate insurance or to operate the asset appropriately could lead to significant losses and damages.

International investments entail risks including fluctuation in currency values, differences in accounting principles, or economic or political instability. Investing in emerging markets can be riskier than investing in established foreign markets due to increased volatility, lower trading volume, and higher risk of market closures. In many emerging markets, there is substantially less publicly available information, and the available information may be incomplete or misleading. Legal claims are generally more difficult to pursue. The Strategy may invest in preferred stock and hybrid securities, which may have special risks. Preferred and hybrid securities may include provisions that permit the issuer, at its discretion, to defer distributions for a stated period without any adverse consequences to the issuer. Some preferred and hybrid securities are non-cumulative, meaning that the dividends do not accumulate and need not ever be paid. A portion of the Strategy's assets may include investments in non-cumulative preferred or hybrid securities, under which the issuer does not have an obligation to make up any arrears to its investors. Preferred and hybrid securities may be substantially less liquid than many other securities, such as common stocks or US government securities. Generally, preferred and hybrid security holders (such as the Strategy) have no voting rights with respect to the issuing company unless preferred dividends have been in arrears for a specified number of periods, at which time the security holders generally may select a number of directors to the issuer's board. Generally, once all the arrears have been paid, the security holders no longer have voting rights. In certain varying circumstances, an issuer of preferred or hybrid securities may redeem the securities prior to a specified date. For instance, for certain types of preferred or hybrid securities, a redemption may be triggered by a change in federal income tax or securities laws. A redemption by the issuer may negatively impact the return of the security held by the Strategy.

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